**DEPARTMENT OF STATE REVENUE**
**LETTER OF FINDINGS: 00-0418**
**Gross Income Tax**
**For the Tax Years 1995, 1996, and 1997**

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## ISSUES

### I. Gross Income Tax – Taxpayer Railroad Company Acting in An Agency Capacity – Inclusion of Receipts for the Maintenance of Joint/Shared Facilities.

**Authority**: IC 6-2.1-2-2(a)(1); IC 6-2.1-2-2(a)(2); Policy Management Systems Corp. v. Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999); Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994); 45 IAC 1.1-1-2; 45 IAC 1.1-1-2(b)(1); 45 IAC 1.1-1-2(b)(2); 45 IAC 1.1-6-10.

Taxpayer argues that the money it received for the maintenance of certain joint/shared facilities was not subject to the gross income tax because taxpayer was acting in an agency capacity at the time it received the money.

### II. Gross Income Tax – Taxpayer Railroad Company Acting in an Agency Capacity – Inclusion of Receipts for the Repair of Foreign Railcars.

**Authority**: 45 IAC 1.1-1-2(b)(1); 45 IAC 1.1-1-2(b)(2); 45 IAC 1.1-6-10.

Taxpayer argues that the money it received for the repair of railroad cars belonging to other railroads was not subject to the gross income tax because taxpayer was acting in an agency capacity at the time it received the money.

### III. Commerce Clause – Receipts Subject to the State's Gross Income Tax.

**Authority**: U.S. Const. art. I, § 8, cl. 3; IC 6-2.1-3-3; IC 6-8.1-5-1(b).

Taxpayer argues that the money it received from the maintenance of joint/shared facilities and the money it received from the repair of foreign railroad cars was not subject to the state's gross income tax by virtue of the protections afforded under the Commerce Clause.

## IV. Abatement of the Ten-Percent Negligence Penalty.

**Authority**: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that the Department is obligated to abate the ten-percent negligence penalty imposed at the time of the original audit.

## STATEMENT OF FACTS

Taxpayer operates a railroad business along its approximately 200 miles of mainline tracks located in Illinois and Indiana. Taxpayer entered into and maintains long-standing agreements with four other railroads governing the maintenance of "joint/shared facilities." These "joint/shared facilities" are specific points along taxpayer's system where the tracks of the four other railroads cross taxpayer's own tracks. By the terms of the various agreements, taxpayer became obligated to maintain these facilities but was entitled to be reimbursed, on a pro-rata basis, for the costs incurred in performing that maintenance work. In addition, taxpayer was reimbursed for the costs of repairing "foreign" railroad cars – rolling stock belonging to numerous other railroad companies – which were received by taxpayer for transport within taxpayer's own system. Taxpayer further argues that the money received from the maintenance of the joint/shared facilities and the money it received for the repair of foreign cars was not subject to the gross income tax because the money was received as a result of conducting business in interstate commerce.

The audit found that income received from the maintenance of the joint/shared facilities along with the income received from the maintenance of foreign railroad cars, was subject to the state's gross income tax. Taxpayer disagreed arguing that it received this income while acting in an agency capacity. An administrative hearing was held to discuss taxpayer's protest, and this Letter of Findings follows.

## DISCUSSION

### I. Gross Income Tax – Taxpayer Railroad Company Acting in An Agency Capacity – Inclusion of Receipts for the Maintenance of Joint/Shared Facilities.

Taxpayer entered into agreements with certain other railroads governing the establishment and maintenance of joint/shared facilities located at specific points along taxpayer's track system. These joint/shared facilities permit the tracks of another railroad to cross over the taxpayer's own tracks. Taxpayer receives a pro-rata reimbursement of those costs incurred in the maintenance of the joint/shared facilities and argues that the reimbursement is not subject to the state's gross income tax scheme. To bolster its agency argument, taxpayer cites to particular provisions of the governing agreements with the four other railroads. Those provisions require taxpayer to undertake the repairs necessary to maintain the joint/shared facilities in proper working order. In addition, the agreements govern the apportionment of any damages attributable to the actions of

taxpayer's employees, incurred while its employees are performing the maintenance activities or injuries incurred as a result of having performed the maintenance activities.

Indiana imposes a gross income tax upon the entire gross receipts of a taxpayer who is a resident or domiciliary of Indiana. IC 6-2.1-2-2(a)(1). For the taxpayer who is not a resident or domiciliary of Indiana – such as taxpayer railroad company – the tax is imposed on the gross receipts which are derived from business activities conducted within the state. IC 6-2.1-2-2(a)(2). However 45 IAC 1.1-6-10 exempts that portion of the taxpayer's income which the taxpayer receives when acting in an agency capacity. 45 IAC 1.1-1-2 defines an "agent" as follows:

> (a) "Agent" means a person or entity authorized by another to transact business on its behalf.
>
> (b) A taxpayer will qualify as an agent if it meets both of the following requirements:
>
> > (1) The taxpayer must be under the control of another. An agency relationship is not established unless the taxpayer is under the control of another in transacting business on its behalf. The relationship must be intended by both parties and may be established by contract or implied from the conduct of the parties. The representation of one (1) party that it is the agent of another party without the manifestation of consent and control by the alleged principal is insufficient to establish an agency relationship.
> >
> > (2) The taxpayer must not have any right, title, or interest in the money or property received from the transaction. The income must pass through actually or substantively, to the principal or a third party, with the taxpayer being merely a conduit through which the funds pass between a third party and the principal.

The Indiana Tax Court in Policy Management Systems Corp. v. Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999) and Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994) reviewed the relationship between imposition of the state's gross income tax and agency principles, echoed the standards set out in 45 IAC 1.1-1-2 and 45 IAC 1.1-6-10, and held that an agency relationship required consent by the principal, acceptance and authority by the agent, and control of the agent by the principal.

Taxpayer misapprehends the elements necessary to establish an agent/principal relationship. Critical to the nature of such a relationship is the presence of a "principal" on whose behalf the putative agent – in this case taxpayer – is acting. In order for the agent to avoid the consequences of the gross income tax, the agent must have no control or authority over the receipts at issue because the receipts simply pass unimpeded through to the principal. Any apparent control which the agent exercises over the receipts is transitory and illusory because, at all times, the agent is simply acting on behalf of the principal. The agent eludes imposition of the gross income tax because the receipts never belong to the agent. *See* IAC 1.1-1-2(b)(2).

In taxpayer's own particular circumstances, there is no "principal" on whose behalf the taxpayer is receiving money obtained for making repairs and maintaining the joint/shared facilities. The fact that the taxpayer has – by virtue of the agreements entered into with the other railroads – surrendered a degree of its autonomy to conduct repair and maintenance activities in any manner it chooses, is alone insufficient to establish an agent/principal relationship. The fact that the manner in which taxpayer conducts its repair activities is subject to the dictates of federal regulators, is also insufficient to establish that taxpayer was acting as an agent in making repairs of the joint/shared facilities. The assertion that taxpayer receives no profit from the maintenance of the joint/shared facilities is entirely irrelevant. 45 IAC 1.1-1-2(b)(2) requires that, in order for the taxpayer to qualify as an agent, the receipts "must pass through actually or substantively, to the principal or a third party, with the taxpayer being merely a conduit through which the funds pass between a third party and the principal."

Essentially, taxpayer entered into agreements whereby it agreed to obligate itself to conduct specified repair and maintenance activities but to receive a partial reimbursement for the costs incurred in conducting those activities. Accordingly, taxpayer falls squarely within the admonition contained within 45 IAC 1.1-6-10 which states that the "reimbursement of a taxpayer's own expenses are *never* excluded from gross income." (*Emphasis added*).

## FINDING

Taxpayer's protest is respectfully denied.

## II. Gross Income Tax – Taxpayer Railroad Company Acting in an Agency Capacity – Inclusion of Receipts for the Repair of Foreign Railcars.

Taxpayer transports railroad cars belonging to numerous other railroad companies along its approximately 200 miles of mainline track. Before these "foreign" railroad cars can be transported along taxpayer's system, they are inspected by taxpayer to make certain that the railroad cars meet federally mandated safety standards. If taxpayer determines that repairs must be made before the foreign railroad car can be transported within taxpayer's system, one of two things will occur: (1) If the repair is minor, taxpayer will perform the repair and bill the foreign railroad for the cost of the repair; (2) If the foreign railroad car requires more extensive repairs, the foreign railroad has the option of retrieving the car and performing the repair itself, or the foreign railroad will permit taxpayer to perform the repair work. In either case, taxpayer receives a reimbursement for the cost of performing the maintenance work on the foreign railroad car. It is these receipts which are the subject of the taxpayer's protest because – according to taxpayer – the receipts were received while taxpayer was functioning in an agency capacity.

Taxpayer has little or no discretion in deciding what repairs are needed or in determining the amount for which it will be reimbursed. The repair work is mandated by the Federal Railroad Administration (FRA). That same agency conducts inspections to assure that necessary repair work is actually performed. The prices that taxpayer can charge for the repair work are established by the Association of American Railroads (AAR), a trade association of United States Railroads to which taxpayer is a subscribing associate member.

Therefore, if a foreign railroad company introduces a railroad car for transport along taxpayer's system and that particular foreign railroad car has a faulty air hose, the FRA will mandate that the air hose be repaired. Since it is a minor repair, taxpayer will automatically undertake the repair. Taxpayer will then bill the foreign railroad by means of a protocol established by the AAR. If the AAR stipulates that repair of an air hose is to be reimbursed at a rate of $100, taxpayer will bill the foreign railroad $100. If the repair of the particular air hose actually costs $50, taxpayer is nonetheless entitled to bill the foreign railroad $100. If the repair of the particular air hose costs taxpayer $150, taxpayer is nonetheless required to bill the foreign railroad $100. It is this absence of control which is central to taxpayer's argument that it operates as an agent when it receives the repair reimbursements.

Taxpayer is correct in its assertion that the absence of control is *one* prerequisite to establishing an agency/principal relationship. "The taxpayer must be under the control of another." 45 IAC 1.1-1-2(b)(1). However, taxpayer's argument does not withstand close scrutiny because there is no principal on whose behalf taxpayer receives the reimbursements for the repair of the foreign railroad cars. The foreign railroad is not the principal. The FRA is not the principal. The AAR is not the principal. None of these parties ever receive the reimbursement for the repair of the foreign railroad cars. The taxpayer itself is merely being reimbursed – with or without a profit – for expenses it incurred in undertaking the repairs. Again, 45 IAC 1.1-6-10 specifically mandates that "reimbursement of a taxpayer's own expenses are never excluded from gross income." Absent any evidence that the reimbursement costs "pass through actually or substantively, to the principal or a third party, with the taxpayer being merely a conduct through which the funds pass between a third party and the principal," taxpayer's argument clearly fails. 45 IAC 1.1-1-2(b)(2).

## FINDING

Taxpayer's protest is respectfully denied.

## III. Commerce Clause – Receipts Subject to the State's Gross Income Tax.

Taxpayer sets out a secondary argument based upon the requirements contained within the Commerce Clause, U.S. Const. art. I, § 8, cl. 3, giving Congress the exclusive power to regulate commerce conducted between the states. Taxpayer argues that receipts from the repair and maintenance of joint/shared facilities and receipts derived from the repair of foreign railroad cars are shielded by the Commerce Clause from imposition of the state's gross income tax.

IC 6-2.1-3-3 codifies the constitutional prohibition placed upon the individual states by the Commerce Clause. Specifically, IC 6-2.1-3-3 provides that "Gross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution."

Taxpayer's argument is apparently based on the presumption that certain of taxpayer's business activities are conducted within interstate commerce. However, taxpayer fails to explain how the payments it receives from undertaking repair work on facilities and rolling stock located within the state, are themselves derived from interstate commerce. Taxpayer offers no explanation as to how these particularized in-state activities can possibly be entitled to the constitutional protection afforded under U.S. Const. art. I, § 8, cl. 3 or IC 6-2.1-3-3.

Taxpayer's ill-defined argument does not meet the standard imposed under IC 6-8.1-5-1(b) which states that "[t]he notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of providing that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

**FINDING**

Taxpayer's protest is respectfully denied.

## IV. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer maintains that it is entitled to abatement of the ten-percent penalty imposed under IC 6-8.1-10-2.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer argues that it made a good faith, conscientious attempt to comply with the state's tax laws and that it was entitled to assume the stance it took based upon past Departmental rulings on the issue of agency. To that end, taxpayer cites to a 1991 Letter of Findings addressing its previous protest of the nearly identical gross income tax issues. In that Letter of Findings, the Department determined that taxpayer was acting in an agency capacity "as to receipts derived from the operation of joint facilities, shared facilities, and safety repairs."

However, taxpayer fails to note that the identical issue was addressed in a 1992 Letter of Findings in which the Department found that receipts derived from the maintenance of its joint/shared facilities and the repair of foreign railroad cars "[were] not received in an agency capacity, but [that] the taxpayer has right, title and interest in the funds received."

Taxpayer fails to note that the identical issues were addressed in a 1998 Letter of Findings in which the Department found that the money it received for the maintenance of its joint/shared facilities were “taxpayer’s receipts. The taxpayer is not merely passing the receipts along, as a conduit, to another person or entity.”

Taxpayer fails to note that the identical issues were addressed in a 1998 Supplemental Letter of Findings in which the Department found that the “receipts at issue were receipts, for services rendered [and that] in the instant situation there is no conduit merely the performance of services.”

Finally, taxpayer fails to take note of the fact that it petitioned the Indiana Tax Court in 1998 for it to address certain tax issues between itself and the Department. However, in its petition to the court, “concerning the gross income tax as applied to certain agency receipts” it specifically conceded the issue and did not raise it on appeal.

Accordingly, by raising the identical agency argument against the determinations contained within an audit conducted in 2000 after having conceded that issue two years earlier, taxpayer has demonstrated that it failed to “use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." 45 IAC 15-11-2(b).

## FINDING

Taxpayer’s protest is respectfully denied.

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